Islamic Finance

Law, Economics, and Practice

This book provides an overview of the practice of Islamic finance and the historical roots that define its modes of operation. The focus of the book is analytical and forward-looking. It shows that Islamic finance exists primarily today as a form of rent-seeking legal arbitrage. An alternative that emphasizes substance rather than form would serve religious and moral objectives better, through mutual and similar financial practices.

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To
Father
& Mother,
who taught me
that religious forms
should continually serve
their central moral substance

Contents

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Mahmoud A. El-Gamal
Frontmatter
More information

List of Illustrations

Preface

In recent years, financial activities conducted under the banner of "Islamic finance" have grown significantly in volume and scope, attracting significant attention worldwide. Numerous books and articles have been published on the topic over the past few decades. Their genres have ranged from highly religious treatises on Islamic law and worldview to highly practical surveys of the latest Islamic financial products to reach the market. Why, one must ask, should one read – let alone write – another book on the subject?

This book provides a qualitative overview of the practice of Islamic finance and the historical roots that have defined its modes of operation. The purpose of the book is not to survey the latest developments in this fast-growing industry. In the current information age, such information is best obtained on the Internet, since it requires updating at rates far exceeding the publication cycles of books and journal articles.

The focus of this book is analytical and forward-looking. I show that, despite the good intentions of its pioneers, Islamic finance has placed excessive emphasis on contract forms, thus becoming a primary target for rent-seeking legal arbitrageurs. In every aspect of finance – from personal loans to investment banking, and from market structure to corporate governance of financial institutions – Islamic finance aims to replicate in Islamic forms the substantive functions of contemporary financial instruments, markets, and institutions.

This supposed Islamization of contemporary financial practice is accomplished by means of modified premodern financial contracts (such as sales, leases, and simple partnerships). The contracts are designed by teams of (1) financial professionals who make and cater to the market for "Islamic" products, (2) lawyers who are skilled in the art of regulatory arbitrage, and (3) jurists or religious scholars who are familiar with medieval juristic texts (mostly in Arabic) and provide certification of the Islamicity of various financial products and services.

To make the classical juristic literature (on which the industry is built) accessible to English-reading audiences, I have provided a translation of one of the most comprehensive surveys of classical Islamic jurisprudence and its contemporary understanding; see Al-Zuhayli (2003). The book in your hands contains the argument that the classical jurisprudence in that survey aimed mainly to enhance fairness and economic efficiency, subject to the legal and regulatory constraints of premodern societies. In this regard, many of the intended economic and prudential regulatory functions of classical contract conditions are currently served by other means that were made possible through advances in communication, legal structures, and information technology.

By attempting to replicate the substance of contemporary financial practice using premodern contract forms, Islamic finance has arguably failed to serve the objectives of Islamic Law (*maqasid al-Shariʿa*): Wherever the substance of contemporary financial practice is in accordance with Islamic Law, adherence to premodern contract forms (with or without modification) leads most often to avoidable efficiency losses, thus violating one of the main legal objectives that defined classical Islamic jurisprudence. Conversely, by focusing on Islamicity of contract forms rather than substance (in part to justify efficiency losses), Islamic finance has often failed to serve the economic purpose for which certain premodern contract structures were codified in classical jurisprudence. This book provides multiple examples of both types of departure from serving Islamic legal objectives. The case is also made that form-oriented Islamic finance is not sustainable in the long term, because of (1) inherent dangers of using sophisticated structured finance methods in Islamic countries with relatively unsophisticated regulators and (2) competitive pressures that dictate convergence to efficient conventional financial modes.

I propose refocusing Islamic finance on substance rather than form. This would entail abandoning the paradigm of "Islamization" of every financial practice. It would also entail reorienting the brand name of Islamic finance to emphasize issues of community banking, microfinance, socially responsible investment, and the like. In other words, I argue that the "Islamic" in "Islamic finance" should relate to the social and economic ends of financial transactions, rather than the contract mechanics through which financial ends are achieved. I provide specific examples of areas where such reorientation of the brand name may in fact provide value to individual customers of the industry, as well as society more generally.

A Note on Terms of Reverence

It is customary in Islamic writings to use terms of reverence when significant religious figures are mentioned. For instance, mention of the Prophet is traditionally

followed by the phrase "*ṣalla Allahu ʿalayhi wa sallam*" (may God bless him and give him peace), and the mention of his companions is traditionally followed by the phrase "*raḍiya Allahu ʿanhu*" (may God be pleased with him). However, Western academic writings conventionally eliminate the use of such terms of reverence. Following the latter convention, I shall not use terms of reverence in this book, as non-specialists and non-Muslims may find them distracting. In the meantime, I assure pious readers that I share their respect for all religious figures. I hope that they will not be offended by omission of printed terms of reverence, which readers may nonetheless vocalize at their discretion.

Mahmoud A. El-Gamal
Houston, December 2005

Glossary and Transliteration

Allāh – God.
amāna – trust, possession of.
ʿaqd – contract.
bāṭil – invalid (contract).
bayʿ – sale.
bayʿ al-amāna – variation on same-item sale-repurchase (*ʿīna*).
bayʿ al-ʿīna – same-item sale-repurchase.
bayʿ al-kāliʾ bi-l-kāliʾ – trading one deferred obligation for another, forbidden based on a tradition with questionable authenticity.
bayʿ al-ʿuhda – variation on same-item sale-repurchase (*ʿīna*).
bayʿ al-wafāʾ – variation on same-item sale-repurchase (*ʿīna*).
bayʿ bi-thaman ājil – credit sale.
companion – immediate follower of the Prophet.
ḍamān – guaranty, possession of.
ḍarar – harm or injury.
dayn – debt or liability for fungible property.
dīnār – Roman gold coins, adopted as currency in early Islam.
dirham – Persian silver coins, adopted as currency in early Islam.
fāʾida – (literally: benefit) interest, plural *fawāʾid*.
fāsid – defective (contract).
fatwā – religious edict or opinion, plural *fatāwā*, anglicized plural *fatwas*.
fiqh – juristic understanding or inference based on Sharīʿa.
fuḍūlī – uncommissioned agent.
gharar – risk or uncertainty, forbidden if excessive and avoidable.
ḥadīth – report of Prophetic or other early Islamic tradition.
Ḥanafī – belonging to the juristic school of Abū Ḥanīfa, see note 24, Chapter 2.
Ḥanbalī – belonging to the juristic school of Aḥmad ibn Ḥanbal, see note 24, Chapter 2.

hiba – gift.
hijra – the Prophet's migration from Makka to Yathrib (later called Madina).
ḥīla – ruse, legal stratagem to circumvent various prohibitions, plural *ḥiyal*.
ḥukm Sharʿī – Islamic legal status ruling.
īdāʿ – fiduciary deposit contract.
ijāra – lease or hire contract.
ijmāʿ – juristic consensus.
ijtihād – juristic inference.
ʿilla – juristic reason or grounds for analogy.
iqāla – contract revocation.
istiḥsān – juristic approbation, to overrule juristic analogy.
istiṣlāḥ – benefit analysis, to overrule juristic analogy.
istiṣnāʿ – commission to manufacture.
Jamāʿat-i-Islāmī – Islamist party founded by Pakistani writer Abu Al-Aʿlā Al-Mawdūdī.
jiʿāla – pledge to make payment.
jurist – *faqīh*, a specialist in Islamic jurisprudence.
kafāla – guaranty offered on behalf of some party.
Mālikī – belonging to the juristic school of Mālik ibn Anas, see note 24, Chapter 2.
manfaʿa – usufruct of a property.
maqāṣṣa – mutual debt clearance.
maṣlaḥa – public or private benefit, plural *maṣāliḥ*.
muḍāraba – silent partnership.
muftī – jurist who issues *fatwā*.
murābaḥa – cost-plus sale, often combined with *bayʿ bi-thaman ājil*.
Al-Ikhwān Al-Muslimūn – Muslim Brotherhood, Islamist group founded by Egyptian teacher Ḥassan Al-Banna.
qarḍ – loan of fungible property.
qirāḍ – silent partnership.
qiyās – juristic inference by analogy.
Qurʾān – ultimate Islamic canon, believed to be the revealed word of God.
rahn – collateral or pawned property in lieu of debt.
ribā – major prohibition of Islam, similar but not equivalent to either usury or interest, see Chapter 3.
ribawī – property subject to the rules of *ribā*.
ṣakk – bond or certificate, plural *ṣukūk*.
salam – forward sale with prepaid price.
sanad – bond or certificate, plural *sanadāt*.
ṣarf – currency exchange contract.

Shāfiʿī – belonging to the juristic school of Muḥammad ibn Idrīs Al-Shāfiʿī, see note 24, Chapter 2.
Sharīʿa – revealed divine law in Qurʾān and *Sunna*.
sharika – partnership, see Chapter 7 for various types.
ṣukūk – bonds or certificates, plural of *ṣakk*.
Sunna – Prophetic or other early Islamic tradition.
tabarruʿ – voluntary contribution.
takāful – mutual guaranty or insurance, used differently in Islamic finance, see Chapter 8.
takhrīj fiqhī – juristic recharacterization of a contract or transaction (usually forbidden) in terms of another (usually permissible).
tawarruq – three-party variation on *bayʿ al-ʿīna*.
tawliya – sale at cost.
ʿurbūn – down payment on purchase, from which call options are routinely synthesized.
ʿurf – customary practice, appeals to which may overrule juristic analogy.
wadīʿa – fiduciary deposit.
waḍīʿa – sale below cost.
wakāla – agency.
waqf – trust or mortmain, plural *awqāf*.
zakāh – obligatory Islamic wealth tax.